

**STATE OF ILLINOIS**  
**ILLINOIS COMMERCE COMMISSION**

The People of the State of Illinois, by and	)	
through Lisa Madigan, Attorney General	)	Docket No. 03-0673
of the State of Illinois, the Cook County	)	
State's Attorney Office, ex rel. Richard A.	)	
Devine, State's Attorney of Cook County,	)	
American Association of Retired Persons,	)	
Citizen Action/ Illinois, Citizens Utility Board,	)	
Environmental Law and Policy Center,	)	
Illinois State Public Interest Research	)	
Group, Inc.	)	
	)	
	)	
Petition for an Investigation into the Condition	)	
of Illinois Power Company	)	

**STAFF RESPONSE TO PETITION FOR INVESTIGATION INTO  
THE CONDITION OF ILLINOIS POWER COMPANY AND  
RESPONSE TO THE PETITION BY ILLINOIS POWER COMPANY**

The Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to the schedule determined by the Administrative Law Judge ("ALJ") hereby submits this Response to the Petition for Investigation into the Condition of Illinois Power Company ("IP") and Response to the Petition by IP.

On November 3, 2003, the Petitioners listed in the caption to this proceeding ("Petitioners") filed with the Illinois Commerce Commission ("Commission") the Petition that initiated this proceeding ("Petition"). On November 14, 2003, a status hearing was held whereby the ALJ established a procedural schedule for (1) IP and Commonwealth Edison Company<sup>1</sup> if it so desired to file a response to the Petition by November 25, 2003, (2) Staff to file a response to the Petition and IP's and ComEd's response by

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<sup>1</sup> On November 25, 2003, ComEd filed a motion to withdraw its petition to intervene in this matter citing the fact that it no longer is seeking to acquire IP and it therefore takes no position on the Petition.

December 5, 2003, and (3) all parties to file a response to Staff's filing by December 10, 2003. Pursuant to the schedule established by the ALJ, Staff hereby responds to the Petition and the Response by IP as follows:

Staff does not recommend that the Petition be granted. A Commission investigation into IP's financial and management condition is not warranted at this point in time, given that the Commission and its Staff have been monitoring IP for financial viability, operational management of electric and gas operations, and customer satisfaction. Such an investigation is unnecessary for the reasons set forth below.

#### I. Financial Viability

Staff has been closely monitoring the financial condition of IP since the summer of 2002, when IP lost its investment grade credit rating.<sup>2</sup> This monitoring has resulted in tangible actions that protect IP's financial viability, within the limits of Commission authority, on a going forward basis.

In 2002, pursuant to discussions with Staff, IP sought and received Commission approval for a Netting Agreement that allowed IP to offset any amounts owed to Dynegy or its affiliates by unpaid amounts (including the interest on the Illinova note) owed to IP by Dynegy or its affiliates. IP was required to file quarterly reports with the Commission describing all netting activity. Additionally, Staff advised IP to seek Commission approval of a suspension in IP's payment of common dividends to Dynegy or Dynegy affiliates. The Commission approved the suspension of dividends with the Netting Agreement (Docket No. 02-0561).

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<sup>2</sup> Moody's Investor Services (Moody's) downgraded IP's senior secured debt from Baa3 to Ba1 on July 25, 2002. Standard & Poor's (S&P) downgraded IP's senior secured debt from BBB- to BB on July 22, 2002.

In 2003, Staff conducted reviews of invoices for inter-company charges from Dynegy to IP and found deficiencies in IP's review of these invoices. Responding to these deficiencies, IP agreed to provide Staff with prior year true-up information and monthly compliance documentation. IP also agreed to perform an annual internal audit of charges from Dynegy and to submit that audit report to Staff. Staff has continued its review of IP's monthly compliance documentation.

Staff's monitoring of IP's financial condition has included the review of financial statements, credit ratings reports, news releases, and Dynegy earnings calls. Staff has also analyzed the financial condition of IP in the context of the Commission's investigation of IP's proposed sale of transmission assets in Docket No. 03-0022 and other financing and related filings. From these analyses, reviews and investigations, Staff has concluded the following:

1. IP's cash flow has declined over the last 12 months. This decline is largely due to the refinancing of low cost debt with 11.5% first mortgage bonds.
2. IP's credit ratings have made its access to the debt capital markets costly and uncertain.
3. Due to its limited access to the debt capital markets, IP relies on timely receipt of interest income on the \$2.3 billion unsecured note payable IP received in exchange for its fossil-fuel power plants.<sup>3</sup>
4. Because IP relies on interest income from the Dynegy note, and because IP conducts a large amount of business with Dynegy affiliates, IP's current credit ratings are due to the financial difficulties of its parent company, Dynegy. On a standalone basis, IP's credit ratings would very likely be at a low investment grade level (i.e., Moody's Baa2 or Baa3 rating; S&P's BBB or BBB- ratings; Fitch Ratings BBB or BBB- rating).

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<sup>3</sup> Hereafter referred to as the "Dynegy Note."

5. In the long-term, IP needs to reduce the book value of its capitalization to a level commensurate with the book value of its transmission and distribution assets.

In 2001 and 2002, IP generated sufficient cash flow from operations to cover capital expenditures.<sup>4</sup> Cash from operations before changes in working capital was 124% of capital expenditures in 2001 and 131% of capital expenditures in 2002. For the 12 months ending September 30, 2003, Staff estimates that cash from operations before changes in working capital was 89% of capital expenditures. Higher interest costs associated with the issuance of \$550 million in 11.5% first mortgage bonds during December 2002 reduced earnings and cash flow in comparison to 2001 and 2002. Staff estimates that refinancing lower cost debt with the 11.5% first mortgage bonds increased IP's annual interest expense approximately \$40-45 million.

IP's cash flow from operations includes \$170 million in interest income on the Dynegey Note. At a composite income tax rate of approximately 40%, the note generates approximately \$102 million in income on an after-tax basis for IP, which constituted 46% of IP's cash from operations, excluding changes in working capital, for the 12 months ending September 30, 2003. Without interest income from the Dynegey Note, IP would not have been able to finance capital expenditures from internally generated funds alone in either 2001 or 2002.

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<sup>4</sup> For the purpose of this calculation, "cash from operations" excludes revenue from instrument funding charges.

IP's credit ratings were downgraded over the last 18 months because of IP's dependence on interest income from the Dynegy Note, along with its other transactions with Dynegy affiliates. Standard & Poor's (S&P) stated:

The ratings on Dynegy reflect the challenges the firm faces in regard to its ability to access capital markets for debt refinancing, preserve an adequate liquidity position, and meet obligations over the next 12 months. Dynegy's expected credit protection measures from the ongoing business lines and its financial health are commensurate with the 'B' corporate credit rating... The ratings on Illinois Power Co., a wholly owned subsidiary of Illinova Corp., reflect the consolidated credit strength of its ultimate parent company, Dynegy. (Standard & Poor's RatingsDirect, July 21, 2003)

Fitch Ratings is more emphatic regarding the primary cause of IP's credit ratings:

The ratings for IP are constrained by those of DYN [Dynegy] due to a large intercompany note [Dynegy Note], as well as the structural and functional ties between the affiliated companies... On a standalone basis, IP has historically demonstrated a stable financial profile, with low risk transmission and distribution operations. (Fitch Ratings, November 4, 2003)

Moody's Investors Service (Moody's) provides further details of the financial and business relationship between IP and Dynegy:

The B3 rating of Illinois Power Company's (IP) senior secured debt reflects the weakened position of Dynegy Holdings, Inc. (DHI: Sr. Unsecured Debt at Caa2), along with the close relationship between IP, DHI, and Dynegy Inc., the parent of both DHI and IP. The rating also considers the predictable cash flows derived from IP's regulated business.

The Dynegy-IP relationship includes the existence of a power purchase agreement between IP and a DHI subsidiary [Dynegy Midwest Generation] for the purchase of electricity through 2004. Additionally, IP has a note receivable due from Dynegy, which was originally taken as consideration at IP for the transfer of its coal-fired generating assets to a DHI subsidiary. IP makes monthly payments to the DHI subsidiary for the purchase of electricity and Dynegy makes semi-annual payments for amounts due under the note. Annual payments under the note from Dynegy to IP are in excess of the annual payments that IP pays to the

DHI subsidiary for purchased power.<sup>5</sup> (Moody's Investors Service, Global Credit Research, Summary Opinion, Illinois Power Company, September 15, 2003).

IP has also publicly acknowledged the direct role that Dynegy's financial situation has played:

Due to our relationship with Dynegy, adverse developments or announcements concerning Dynegy have affected our ability to access the capital markets and to otherwise conduct our business. We are particularly susceptible to developments at Dynegy because we rely upon an unsecured Note Receivable from Affiliate for a substantial portion of our cash flows. (Illinois Power Company, Quarterly Report on SEC Form 10-Q for the Quarterly Period Ended September 30, 2003, p. 17).

IP also describes its constrained liquidity and access to capital and the associated risks in considerable detail:

Without the additional support from Dynegy through its prepayments of interest on the Note Receivable from Affiliate, our cash flows are insufficient to satisfy our debt service obligations and other capital resource requirements.

...

Due to our non-investment grade credit ratings and other factors, we do not have access to the commercial paper markets, and our access to the capital markets is limited. These factors, along with the level of our indebtedness and the fact that we do not currently have a revolving credit facility, will have several important effects on our future operations. First, a significant portion of our cash flows will be dedicated to the payment of principal and interest on our outstanding indebtedness, including the transitional funding trust notes, and will not be available for other purposes. Second, our ability to obtain additional financing for working capital, capital expenditures, general corporate and other purposes is limited.

Because we have no revolving credit facility and no access to the commercial paper markets, we rely on cash on hand, cash flows from

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<sup>5</sup> On this last point, Moody's is mistaken. Payments to Dynegy Holdings affiliates for purchased power far exceed interest on the Dynegy Note. In 2002, IP purchased \$486.4 million of power from affiliates. (Illinois Power Company, Annual Report on SEC Form 10-K for the Year Ended December 31, 2002, p. F-16).

operations, including interest payments under our \$2.3 billion Note Receivable from Affiliate, and liquidity support which has been committed by Dynegy, to satisfy our debt obligations and to otherwise operate our business...

For the near term, we will continue to rely on a support commitment by Dynegy in order to satisfy our obligations. As part of our long-term plan, we will consider one or more liquidity initiatives including, among other things, a revolving credit facility or additional debt issuances. We believe our liquidity and capital resources, including our support commitment from Dynegy, are sufficient to satisfy our obligations over the next twelve months...

Our ability to execute one or more liquidity initiatives successfully is subject to a number of risks. These risks include, among others, our ability to obtain new bank or other borrowings and the financial effects of our relationship with Dynegy. (Illinois Power Company, Quarterly Report on SEC Form 10-Q for the Quarterly Period Ended September 30, 2003, p. 20).

Dynegy's recent debt restructuring in August of 2003 has stabilized its financial condition over the last year. Through its various asset sales and securities issuances, Dynegy has reduced its debt maturities to \$174 million in 2004 and \$100 million in 2005. Further, Dynegy's \$1.1 billion credit facility expires in February 2005. (Credit facilities usually have terms of three years or fewer.) Excluding transitional funding instruments, which have a dedicated cash flow stream, IP's next debt maturity is March 2005 when \$70 million in mortgage bonds come due. (Dynegy, Quarterly Report on SEC Form 10-Q for the Quarterly Period Ended September 30, 2003, p. 21).

Although Dynegy and IP's financial condition has stabilized, the credit rating agencies are uncertain whether Dynegy's ongoing businesses will generate enough cash flow to reduce its debt burden enough to return Dynegy and IP's financial condition to investment grade levels. The next significant milestone will be whether and on what terms Dynegy will be able to obtain a new credit facility in February 2005. The current

credit facility limits principal repayments on the Dynegy Note to \$200 million, but permits Dynegy to prepay interest.<sup>6</sup> If Dynegy's prospects worsen or if banks' willingness to lend to the energy sector declines, a new credit facility might further restrict Dynegy's ability to pay or prepay interest on the Dynegy Note to IP. In summary, Dynegy and IP should have sufficient cash flow to meet on going needs during the next year. Dynegy's ability to continue to make interest payments under the Dynegy note in the intermediate term and whether Dynegy remains a viable entity in the long term, remains to be seen.

As the discussion above demonstrates, a Staff investigation of, and a further report on, IP's financial condition are unnecessary. Staff has been monitoring, and will continue to monitor closely, the financial conditions of both IP and Dynegy. Staff will also continue to keep the Commission informed of developments.

## II. Financial Statements

Paragraph 18 of the Petition states that at a minimum, IP should be required to provide comprehensive financial statements (on the belief that IP does not file its own financial statements), a report of actual capital expenditures and a capital expenditures budget, a copy of the purchased power agreement between IP and Dynegy Midwest Gen., and a report of financial transactions between IP and Dynegy. The Petitioners are incorrect with respect to the need for financial statements, because IP does file its financial statements with the ICC and FERC on an annual basis and with the SEC on a quarterly basis.

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<sup>6</sup> A security agreement between Dynegy and Dynegy Holding's second priority secured note holders limit interest prepayments on the Dynegy Note to 12 months.



### III. Operational Management of Electric and Gas Operations

Current information on electric and gas operations and service reliability does not support the need for a management audit of IP.

IP, along with all other public electric utilities in Illinois, is required to file an annual electric reliability report pursuant to Section 16-125 of the Public Utilities Act and the Commission's electric reliability rules in 83 Ill. Adm. Code 411. Each year, Staff assesses each utility's reliability report and prepares an evaluation of the utility's reliability performance for the calendar year. IP has been submitting annual reliability reports to the Commission each year since 1998.

Staff's assessment of each utility's annual reliability report includes an evaluation and analysis of the utility's ability to provide reliable service. Section 8-102 of the Public Utilities Act in part states:

The Commission may conduct or order a management audit or investigation only when it has reasonable grounds to believe that such audit or investigation is necessary to assure that the utility is providing adequate, efficient, reliable, safe and least-cost service . . .

Based on assessments of IP's past annual reliability reports and on data collection and field work over the last few years, Staff has concluded that IP is providing electric service that is comparable to the service supplied by the other Illinois electric utilities. Some of Staff's work on this issue is documented in the "Assessment of Illinois Power Company's Reliability Report and Reliability Performance," which is attached to the Commission's order in Docket No. 03-0157, dated March 12, 2003.

In Docket No. 01-0171, Staff has reviewed IP's management of its gas storage facilities and identified areas of concern. IP, along with all other public gas utilities in Illinois, is required to file an annual reconciliation of gas purchases pursuant to Section 9-220 of the Public Utilities Act and the 83 Ill. Adm. Code 525, the Purchased Gas Adjustment Clause. Staff's testimony of IP's actions in Docket No. 01-0701 contained information that related to the condition of IP's gas storage operations. Staff would also note that Docket No. 01-0701 is marked heard and taken, but the proceeding has yet to come before the Commission.

Staff's testimony (ICC Staff Exhibit 2.0) in Docket No. 01-0701 raised several concerns regarding IP's storage operations. In particular, Staff recommended an adjustment due to the additional costs IP incurred as a result of the reduction in peak day capacity of one of its storage fields.

In support of the adjustment, Staff's testimony noted that the IP had reduced the peak day capacity of two of its largest storage fields, which Staff noted was an extremely uncommon occurrence. Staff also noted that IP had experienced a large decrease in the number storage field supervisors as well as a significant reduction in the amount of storage field capital expenditures from historical levels. Finally, Staff noted a reduction in IP's ability to identify problems or conduct thorough root cause analyses of problems at its storage fields. Based upon the above information, Staff concluded that IP's inability to operate its storage operations in a safe, reliable, and efficient manner caused its ratepayers to incur additional costs.

IP is required to comply with the minimum federal pipeline safety standards contained in 49 CFR 192. This federal standard is codified as 83 Ill. Adm. Code 590. Further, IP is required to comply with the Illinois Gas Pipeline Safety Act (220 ILCS 20), which is codified as 83 Ill. Adm. Code 520. The Staff members monitoring IP's compliance with Part 520 and Part 590 indicate that IP's performance is adequate and that it is currently meeting these requirements.

In summary, Staff has been monitoring the operational management of IP's gas and electric operations. IP's electric and gas service reliability are comparable to other utilities in Illinois and it is complying with federal and state safety requirements. Staff has made itself aware of service reliability issues in IP's service territory and has induced the utility to take action to correct known problems on the electric side. Staff has identified issues that have affected the cost of gas to consumers and gas storage field safety and reliability. Staff has made the Commission aware of the gas cost issue and proposed adjustments in an ongoing proceeding.

#### IV. Customer Satisfaction

A review of Consumer Services Divisions' complaint records from IP customers indicates a reduction in overall service complaints in 2003 from 2002. Per the Consumer Services Division Annual Report, IP's justified complaints were at 6% of total complaints filed informally in 2002. The Electric Survey Results, as posted on the ICC website, reports the survey results of IP customers' view of reliability is comparable and in some cases better than other electric utilities operating in Illinois.

In September 2003, the Cities of Champaign and Urbana jointly filed an informal complaint against IP regarding customer service and reliability issues. The Cities of Champaign and Urbana filed this informal complaint after receiving numerous complaints from citizens and businesses and after holding a public hearing in June 2003. The issues included the following: a decline in customer service; lack of availability, accountability, and responsiveness on the part of IP employees; delays in scheduling and completion of new installations; and service reliability for high-tech firms. IP has developed a remedial action plan to address the issues raised by the Cities and is currently working with the Cities to implement the plan.

V. Response to IP

Staff has reviewed IP's response and notes that said response asserts a number of facts which Staff has no reason to dispute. Staff has no further comment on IP's response.

**WHEREFORE**, for the foregoing reasons, Staff respectfully recommends that Petitioners' request for an investigation into the financial condition and management of Illinois Power Company be denied. However, Staff notes that following the failure of passage of legislation sought by ComEd and IP and Exelon's and IP's joint termination of the agreement by which Exelon would have acquired substantially all of the assets and liabilities of IP, Dynegy President and CEO Bruce A. Williamson stated that:

Our first priority will be to improve Illinois Power's financial condition by creating a sustainable cost structure for this business. We will work closely with the Illinois Commerce Commission and the unions throughout this process.

We will ensure safe, reliable and affordable service for our electricity and natural gas customers in Illinois while we restructure Illinois Power to make it a sustainable business and implement changes as soon as possible to cut costs,<sup>7</sup>

If this statement was intended to mean that IP may reduce its personnel and if IP in fact takes action to substantially reduce its utility operations personnel, then Staff will reevaluate its position on the need for further investigation into IP's financial condition and management.

Respectfully submitted,

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JOHN C. FEELEY  
JOHN J. REICHART

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Counsel for the Staff of the  
Illinois Commerce Commission

December 5, 2003

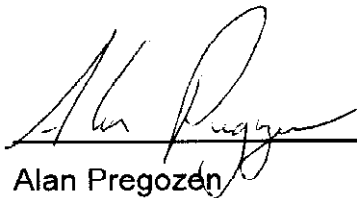
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<sup>7</sup> Dynegy Inc., Form 8-K, Exhibit 99.1, filed November 24, 2003.

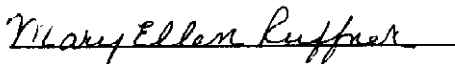
State of Illinois       )  
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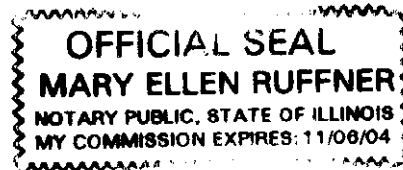
Alan Pregozen, of lawful age, being duly sworn on oath, states that he is Manager of the Finance Department in the Financial Analysis Division; that he has read the foregoing Response and knows the contents of Section I; and that the facts therein stated are true as he verily believes except for the paragraph addressing the 2003 Staff review of inter-company charges. (This paragraph is verified by Bill L. Voss in a separate affidavit.)

Executed on December 4, 2003

  
\_\_\_\_\_  
Alan Pregozen

Subscribed and sworn to before me  
this 4<sup>th</sup> day of December, 2003

  
\_\_\_\_\_  
Notary Public

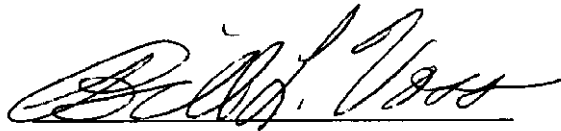


My Commission expires 11-6-04

State of Illinois       )  
                                  ) SS  
County of Sagamon)

Bill L. Voss, of lawful age, being duly sworn on oath, states that he is a Technical Assistant in the Financial Analysis Division; that he has read the foregoing Response and knows the contents of the paragraph in Section I addressing the 2003 Staff review of inter-company charges; and that the facts therein stated are true as he verily believes.

Executed on December 4, 2003



Bill L. Voss

Subscribed and sworn to before me  
this 4<sup>th</sup> day of December, 2003

  
Notary Public



My Commission expires 11-6-04

State of Illinois       )  
                                  ) SS  
County of Sangamon)

Harold L. Stoller, of lawful age, being duly sworn on oath, states that he is the Director of the Energy Division, Staff of the Illinois Commerce Commission; that he has read the foregoing Response and knows the contents of Section III; and that the facts therein stated are true as he verily believes.

Executed on December 4, 2003



Harold L. Stoller

Subscribed and sworn to before me  
this 4<sup>th</sup> day of December, 2003

  
Notary Public



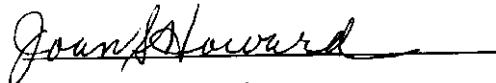
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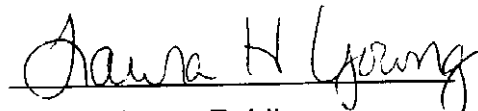
State of Illinois       )  
                                  ) SS  
County of Sagamon)

Joan S. Howard, of lawful age, being duly sworn on oath, states that she is a Consumer Policy Analyst in the Consumer Services Division; that she has read the foregoing Response and knows the contents of Section IV; and that the facts therein stated are true as she verily believes.

Executed on December 4, 2003

  
Joan S. Howard

Subscribed and sworn to before me  
this 4<sup>th</sup> day of December, 2003

  
Notary Public

My Commission expires 07-22-2007

